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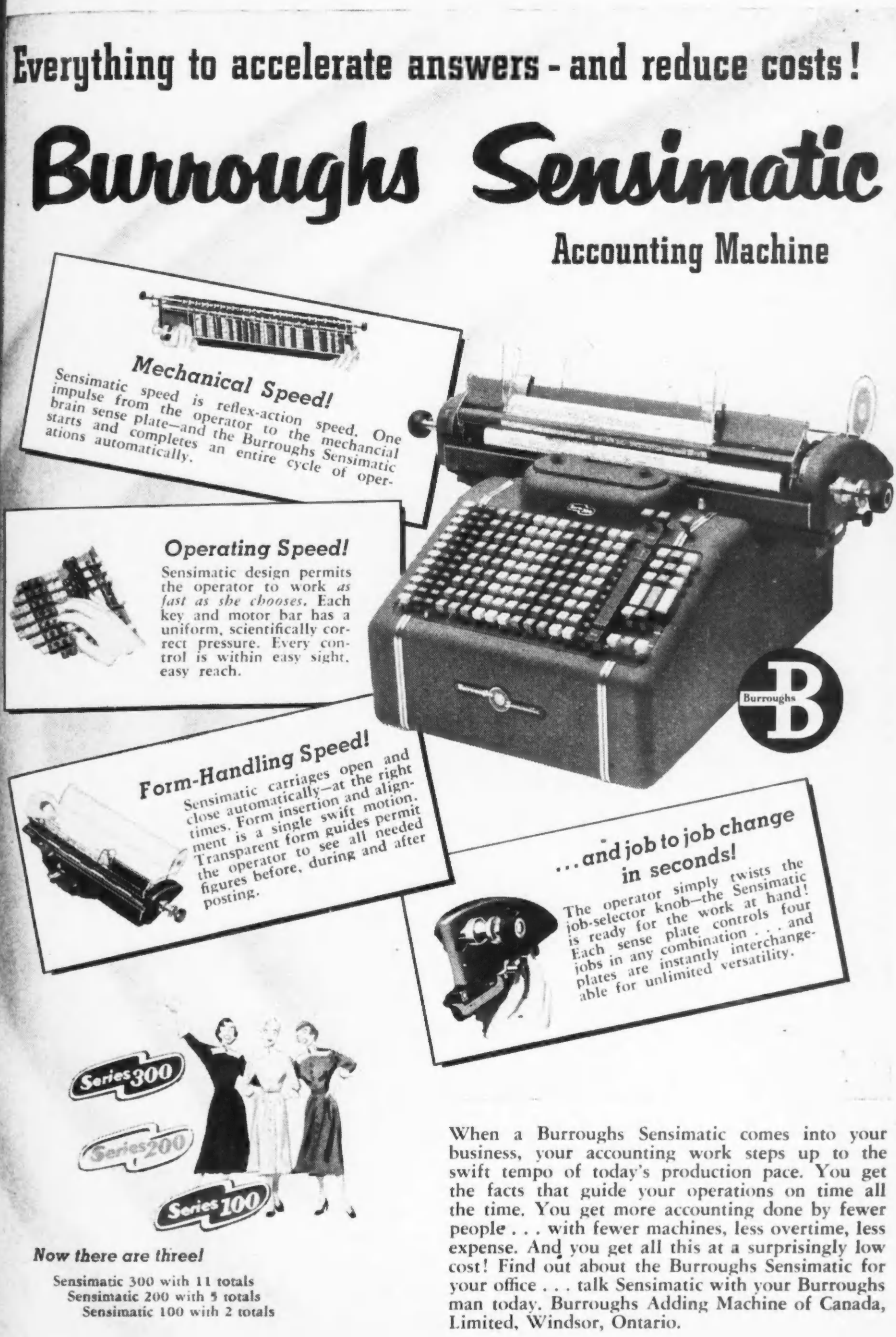

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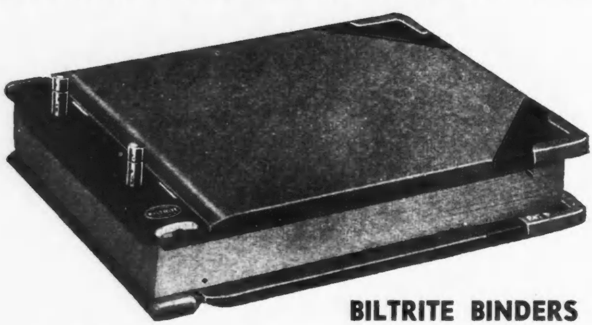

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VOLUME 61 DECEMBER 1952 NUMBER 6

Christmas Message from Your President

IN TIMES of swift and violent change and threatened change such as we live in, Christmas is a welcome occasion since it honours things which are constant and quiet: our spiritual values, love of family and friends and kind thoughts exchanged with associates wherever they may be.

The mutual respect and understanding essential to a happy and peaceful world are being laboured over in various arenas by men and women of religion, politics, diplomacy, and the natural and social sciences. We in our gatherings of chartered accountants are working towards the same ends, in our provincial and national meetings where we meet not only our fellow members but visitors from other lands and in our participation in the great congresses on accounting, "The International" and "The Pan American". In this way we supplement in an intimate fashion the more dramatic efforts of the groups of men and women first mentioned.

It is in this mood, partly pensive and partly hopeful, that I offer my fellow members of the Canadian Institute best wishes for a Merry Christmas and a Happy New Year.

PAR COURTOISIE envers mes confrères dont le français est la langue maternelle, j'aimerais envoyer aussi mon message en français ce qui prouvera combien je crois à l'usage grandissant des deux langues de notre pays.

Parmi les soucis et les craintes qui nous menacent, la fête de Noël se presente comme la garantie de nos biens les plus précieux: de nos valeurs spirituelles, de l'amour de la famille et des voeux de bonne amitié que nous échangeons avec nos amis où qu'ils se trouvent.

Hommes et femmes de toutes sortes, religieux, diplomates, politiciens, ceux qui s'occupent des sciences naturelles et sociales, tous travaillent sans relâche dans des organisations diverses à établir le respect et la compréhension mutuels qui sont indispensables à la construction d'un monde heureux et paisible.

Nous autres dans nos réunions des comptables agréés, nous tendons vers le même but; que ce soit dans nos réunions provinciales ou nationales où nous ne rencontrons pas seulement des confrères mais aussi des visiteurs des autres pays, ou bien dans notre participation aux grands congrès, — "The International" et "The Pan American" — nous suppléons d'une manière intime aux efforts plus dramatiques des hommes et des femmes que je viens de citer.

C'est dans cette atmosphère à la fois pensive et pleine d'espoir que je présente à mes confrères de l'Institut Canadien mes meilleurs voeux pour un JOYEUX NOEL et une BONNE ANNEE.

LORN MCLEAN

COMMENT AND OPINION

The Companies Act Committee

THE Special Committee of the C.I.C.A., which was set up more than a year ago to consider the Dominion Companies Act and prepare a submission for its amendment, has almost reached the end of its travails, and quite possibly it will have done so by the time this note is published. At the time of writing the committee, which comprises eight persons, has met 36 times, has written and rewritten its submissions, received criticisms and comments on its initial report from accountants in all parts of the country, considered all of these, and then rewritten a great part of its report, which, it is hoped, will be its final form. Not only that: the committee (which, it will be recalled, was asked by the Ontario Institute to prepare a submission on the Ontario Companies Act), has already appeared with its submission before public bodies on three separate occasions, each of them stretching over two days of question and answer and much explanation and exposition.

In the spring, the committee appeared before a select committee of the Ontario Legislature charged with the preparation of a Companies Bill, with the result that practically all of the committee's recommendations were incorporated in an interim draft Bill subsequently produced by the Legislative committee. This draft Bill will, it is expected, form the basis of the Bill to be introduced to the Ontario Legislature in the spring of 1953. In October, our committee, having by then largely completed its review of its own submission, appeared again before the Ontario Legislative committee and this time expressed its considered views on the matters contained in its original tentative submission as well as upon other provisions contained in the Legislative committee's interim draft Bill. The warm reception our committee received and the keen interest in its recommendations displayed by the members of the Legislative committee were most encouraging.

In October the committee received news that the Dominion-Provincial Conference on uniform company law would be reconvened in Ottawa after a lapse of some five years, and permission to attend and submit its brief was at once besought by the committee, and granted. Three members of the committee repaired to the capital and once again submitted their recommendations and were themselves submitted to some very thorough quizzing by the Dominion and provincial representatives. The object of the Dominion-Provincial conference, which is composed of senior permanent officials charged with the administration of the companies branches of their respective governments, is to endeavour to agree upon the greatest possible uniformity in the eleven statutes respecting companies, an object somewhat different from that of the Ontario Legislative committee.

While the results of the Ontario committee's labours will be the presentation of a Bill in the near future, no such quick action can be expected from

the other governments represented at the Dominion - Provincial conference. Moreover, it is not unlikely that the Legislature and government of any Province would welcome representations from its own provincial Institute of Chartered Accountants, directed specifically to its own Companies Act, rather than a submission such as that of the C.I.C.A. committee, which refers only to the Dominion statute. This is true even though the C.I.C.A. committee's recommendations were made with the intention that they would be recommended to all governments, provincial as well as federal.

The C.I.C.A. committee was heard with the keenest attention and interest by the federal and provincial officials who were present, and there is every reason to believe that their lengthy and arduous labours will not go unrewarded. The rest is up to the provincial Institutes.

Are Receipts Income?

The answer to the query at the top of this note would appear to be yes. In the past few months four judgments have been pronounced to that effect, one in the Exchequer Court of Canada, three in the Income Tax Appeal Board, and there have in earlier years been similar decisions by both courts. In all but one of these it has been held that amounts received by a taxpayer in a taxation year from his business must be brought into account for tax purposes even though an obligation to furnish goods or services or to make refunds in a succeeding year is attached to the sums received at the time of their receipt. That these decisions run counter to the accounting concept of business income goes without saying, a fact not unacknowledged by some of the judges, who have held, sometimes with an expression of regret, that in this matter accounting principles have been displaced by the language of the statute.

Readers who are interested in this question — we fancy most of them are — will find a valuable discussion of the subject in this number written by Professor J. E. Smyth of Queen's University, and we ourselves hope to discuss the matter in *The Tax Review* of this month or next. We have read all of the Canadian decisions on the question, one decided in 1938, the second in 1944, and a considerable number decided in the past year or two. In only one of these, and that the very first, was the accounting concept found acceptable. In that case Mr. Justice Angers held that a so-called "reserve" for estimated refunds on the return of vinegar containers in a succeeding period was not a reserve of profits which had been earned in the year of receipt, and that the amount thereof did not enter into the computation of the profits of that year. Unfortunately this judgment was later questioned by Mr. Justice Thorson who held in 1944 that tax was expressly imposed on income *received* not on income *earned,* and that income was received if the recipient's right thereto was absolute and unrestricted as to its use, enjoyment and disposition.

The Income Tax Appeal Board, faced with this conflict of opinion in the Exchequer Court, has now come up with what seems to be an astonishing conclusion. Some time ago, the full Board, in a unanimous judgment, rejected the view that the IWTA taxed profits *received* rather than profits *earned* (a view which Thorson P. had elaborated on further in the famous *Trapp* case) but this notwithstanding, two members of the Board have recently held that the Act does in fact tax sums received in a taxation year to which the recipient's right at-

taches absolutely and without restriction in that year notwithstanding that the receipts are not earned in that year. The Board has, however, not stopped there. In the 1944 case Thorson P. had held that a deposit received in one year for services to be rendered in the future should not enter into the computation of the income of the year of receipt if the recipient had not an absolute right to enjoy it in that year. The Income Tax Appeal Board apparently holds that the test of an absolute right to enjoy moneys received is whether or not the recipient has a right to use such moneys or whether they are affected with a trust. From this it would appear to follow that in the view of the Income Tax Appeal Board all receipts of a year except trust moneys are to be brought into the computation of that year's income.

If the reader is not already confused, here is the latest development. In the most recent decision of the Exchequer Court Mr. Justice Cameron acquiesced in Mr. Justice Thorson's view in the 1944 case and arrived at a decision which is a blend of both the earnings concept and the receipts concept. The case in question concerned a wholesale news distributor, and Mr. Justice Cameron held that where a sale of periodicals was completed in one year the whole of the purchase price must be brought into account in computing the profits of that year without any provision for estimated refunds on the return of periodicals which the wholesaler would be obliged to take back in the following year.

We'll leave it there for the moment, in the hope that the matter will be clarified either by the Courts or by Parliament. The present state of the law is surely intolerable.

The Observation of Clients' Wage Payment Procedures

By Lloyd O. Morley, C.A.

Misappropriation of payroll funds is most difficult to prevent and discover

WAGE frauds are more common than any other type because they are the most difficult to guard against by internal check and to discover by audit. Manipulation of the payroll and misappropriation of payroll funds can easily be carried out by a single employee unless the proper safeguards are provided. Even with good safeguards payroll frauds can be carried out with comparative ease when there is collusion between two employees. An effective system of internal control over the preparation and distribution of payrolls is essential if the possibility of fraud is to be reduced to a minimum. Such a system must provide for the segregation of the duties of employment, timekeeping, and payment. This paper is concerned with the third of these subdivisions of payroll work: the observation of clients' wage payment procedures. The purpose of observing wage payment procedures is to ascertain whether they provide all reasonable safeguards against the improper diversion of funds provided for payroll purposes.

Fraud in payrolls always involves overstatement of the total of the payroll, and usually involves either:

1. padding the payroll by including names of new employees before they have started to work, or names of employees who have left, or names of men who are simply non-existent, or who exist but do not work for the company;
2. overstating payroll footings, carry-forwards, etc.;
3. overstating earnings of certain employees;
4. failure to account for unclaimed wages, over-payments, etc.

The first type of fraud is most likely to be discovered at the actual observance of the pay-off. The auditor should, after observing the distribution of the payroll, retain it until he has checked the footings and carry-forwards, and whenever possible should also select it as one of the payrolls on which he carries out detailed tests of employees' earnings, which may bring to light the other types of fraud mentioned above.

Observation of Procedures in Paymaster's Department

The observation of clients' wage payment procedures will of course vary to some extent according to the type of business, rate of labour turnover, method of payment, system of internal check, etc.

The auditor should ascertain if the

completed payroll is made up by the timekeeping department, and a cheque requisition made out for the net total before the payroll comes into the hands of the paymaster, who should be concerned only with distributing the amounts shown on the payroll handed to him. If he finds that the paymaster has some part in preparing the payroll, the auditor must extend his enquiry to include the additional duties of the paymaster.

(*i*) *Employees paid by cheque*

When payment is made by cheque it cannot be assumed that fraud is really much less likely than when payment is made in cash. The manager of the insurance department of a company manufacturing cheques and payroll systems stated in an article in *The Journal of Accountancy,* February, 1947, that payroll cheques are now so numerous that it is probable they outnumber cheques issued for all other purposes, and that when a great many people receive their pay in cheques, the cheques become progressively easier to negotiate. Merchants and bank cashiers become familiar with the form and appearance of the payroll cheques issued by concerns well-known in their communities, and frequently accept them without closely scrutinizing the cheques or requiring the negotiator to identify himself.

The auditor should satisfy himself that separate series of cheques, pre-numbered by the printers, are used for payrolls, and that every cheque is accounted for in a formal record of the serial numbers of payroll cheques, both used and unused, which should be kept under the paymaster's supervision. The author of the article just mentioned also says that it is impossible to place too much emphasis on the necessity for safely storing blank payroll cheque forms. Where blank cheque forms are easily accessible they present a considerable temptation to employees and to thieves, who may fill out a number of the cheques, probably on the company's cheque-writing machine, forge the signatures and negotiate them. He reported having seen 16 cases of theft reported in the American daily papers in a period of a few months, in all of which the only articles stolen were blank cheques and cheque-writing machines.

If a cheque-signing machine is used, it should be ascertained that a record of the meter-reading of the machine is kept and reconciled with the number of cheques signed. The signature plate should be kept under proper custody by the officer whose signature it bears, and, if practical, used only by an employee who has no part in preparing the payroll cheques. A limiting clause printed on the face of payroll cheques, such as "Not valid for more than $300", thus requiring manual signature of larger cheques, may also be suggested if not already in use.

Payroll bank accounts should never be left un-reconciled for more than a month, and the reconciliations should be made by an employee in the accounting department who takes no part in the preparation of payroll cheques and records.

(*ii*) *Employees paid in cash*

If employees are paid in cash the auditor should see that at least two employees in the paymaster's office are engaged in placing the money in the pay envelopes, and that they check the amount received from the bank with the total of the payroll. Whenever practical, they should both check the amount placed in each envelope with the net amount listed on the payroll. These employees should not have any part in preparing the payrolls.

(b) Attendance at Pay-off

Any observance of the actual pay-off should not be carried out as an isolated

operation, but should be made a part of the review of wage payment procedures and of the detailed examination of payrolls.

Before making his visit the auditor should review or prepare permanent file notes on the procedures and controls used in the client's plant in the preparation and distribution of payrolls, so that he will be aware of the weaknesses and likely types of fraud in the particular circumstances.

The possibility of fraud in the form of padding of the payroll makes it necessary for the auditor to be extremely methodical and thorough when observing the pay-off. The last envelope remaining unclaimed may be that for a "dummy" padded on to the payroll, and the auditor must be prepared to take sufficient time to satisfy himself that every unusual or unclaimed item is genuine.

The auditor should attend the pay-off without advance notice of any kind, and it is suggested that he should take with him the assistant who is to do the detail work on the payroll. Two observers are far more effective than one, as a single person may be so busy checking out pay envelopes or ticking off names that he has little time to observe procedures.

When all the pay envelopes have been made up, the auditor should take control of them, not sole control of course, and check off the names to the payroll, to ensure that he has an envelope for every name appearing on the payroll. If payment is made in cash and the internal control is weak, he may consider it desirable to check the contents of some or all the envelopes with the net pay shown on the payroll. In the case of a very large payroll, he may have to limit his tests to certain departments or sections of the payroll. At the same time he should also take control of the payroll so that he may foot it and also, wherever possible, carry out detail tests such as checking time worked, rates of pay, calculations, etc., without delay.

Mr. Lloyd O. Morley, C.A., is a native of Saskatchewan, but was educated in England where he qualified as a C.A. in 1938. After serving in the armed forces during World War II, he returned to Canada in 1946 and was admitted to the Ontario Institute. He is at present with Price, Waterhouse & Co., Toronto.

Control of the pay envelopes must be retained until every envelope has been handed out or returned to the cashier or some other responsible official as unclaimed. Failure to do this would make it easy for the paymaster to extract and pocket pay envelopes for "dummies" shown on the payroll. And it would be very embarrassing to an auditor who had observed and been satisfied with a payroll distribution to learn later that the paymaster had pocketed a "dummy" envelope right under his nose.

The actual pay distribution should be made by two employees of the pay office under the paymaster's supervision, and the auditor's assistant should control the envelopes to ensure that every envelope given out is handed to a properly identified employee. The method of identifying employees varies in different plants and it will often be found that the pay clerks know nearly all the employees and ask for no identification. Probably the best method of identification is to have plant foremen or supervisors present at the pay distribution to confirm the identity of the men, who should be asked to call out their names and numbers. This method should also be followed where Brinks distribute the pay envelopes. The auditor should not rely solely on receipts or numbered badges for identification of the men.

Asking employees for their names and numbers has its advantages. When a member of the staff of a Toronto firm of chartered accountants was observing a pay-off in a bottling plant in the United States and asked the girls for their numbers, they often gave their telephone numbers, and some added, "What's yours?" No doubt he followed up these discrepancies.

If he finds cases of one employee's pay being given to another employee, the auditor should immediately investigate and strongly recommend that the practice be stopped unless a written request from the absent employee is held by the claimant. Sometimes the pay envelopes for a group of employees are handed to a foreman for distribution. This is an undesirable practice and the auditor should try to have it discontinued. If this cannot be done he should recommend that the paymaster or another officer should frequently attend without warning at pay-offs by foremen, particularly in the construction and other businesses where labour turnover is high.

(c) Unclaimed Wages

When the normal pay distribution has been completed there will probably be some envelopes remaining unclaimed. If the auditor remains in the plant for the remainder of the day, employees claiming their pay after the normal distribution hours may be required to present themselves to him and be identified by someone outside the paymaster's department. In any case he should not release control of the unclaimed envelopes until he has seen them listed and handed over to the cashier or another responsible official. The auditor should retain a copy of the listing and, if possible, should have it reviewed by an officer of the company who knows the employees and can confirm that they are absent. If this is not possible he must satisfy himself as to the genuineness of every unclaimed item by talking to foremen, examining employment officer's records and time cards, or other means. Where labour turnover is high and unclaimed wages are considerable, the auditor should compare unclaimed wages in the payroll distributed by him with unclaimed wages reported in previous weeks to ascertain if the latter are suspiciously low.

He should, of course, ascertain how long the paymaster retains unclaimed wages and should confirm that they are deposited with the cashier as soon as reasonably possible. He should ensure that proper records and control are kept in the paymaster's office over unclaimed wages held there, and that no clerk is allowed to pay out unclaimed wages without written authority.

(d) General

The auditor should ascertain if employees in the payroll department are bonded, and should suggest that their duties be rotated without warning and that senior accounting officials should occasionally attend payroll distributions. Finally, he should review the payroll audit program in the light of his experience in observing the wage payment procedures and report to his client any weaknesses or deficiencies disclosed.

The American Accountant In Practice

By T. Coleman Andrews, C.P.A.
Past President, The American Institute of Accountants

The organization and development of the accounting profession in the U.S.A.

IT is essential to accurate understanding of public accounting practice in the United States that the source of the practitioner's professional status there be clearly understood.

Contrary to the situation here in the U.K., where an accountant gets his professional recognition from the profession itself, it is traditional in the United States that public practice of accounting is deemed to be an activity affected with the public interest and, therefore, a proper subject of State regulation. Hence, those who engage in public accounting practice get their recognition from one of the forty-eight States, the District of Columbia, or one of the territories or insular possessions. In other words, the public practitioners are "certified" pursuant to law.

The common title of the public practitioner is "Certified Public Accountant". However, in some States there is another class known simply as "Public Accountants". In both cases, however, the designation is a legal one.

In general, the designation "Certified Public Accountant" has been granted only to those who have taken a written test of their knowledge of accounting theory, accounting practice, auditing, and commercial law, although a few States include one or more other subjects.

To explain generally how there came to be two designations, I will illustrate by reviewing the situation in my own State of Virginia, which is fairly typical.

Virginia first adopted legislation regulating public practice of accounting in 1910. This legislation provided that those who satisfied its requirements would be designated "Certified Public Accountants", but since there were no certified public accountants prior to that time, the initial legislation waived the examination for those who were deemed to be qualified by experience. Hence, the first Virginia C.P.A.s received what we call waiver certificates. These certificates were unqualified and entitled those who held them to full recognition as certified public accountants. The certificates initially issued by most of the States were waiver certificates.

It might be of interest to note in passing that each of the members of Virginia's first Board of Accountancy voluntarily submitted to examination by

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the other members. Thereafter, only those who took and satisfactorily passed written examinations were to receive the right to call themselves certified public accountants, and the Virginia State Board of Accountancy, which had been created by the *Accountancy Act,* was charged with giving the annual examinations and otherwise administering the Act. This initial law did not prevent anyone from practising public accounting. It only prohibited anyone from calling himself a certified public accountant if he had not acquired the right to do so as provided by the law.

This procedure prevailed until 1926, when strong protest was made to the General Assembly of the Commonwealth by the uncertified practitioners that their ability to earn a livelihood was seriously impaired by their lack of legislative recognition. The *Accountancy Act* was then changed to what is commonly called "two-class legislation". Under the revised Act those uncertified practitioners who were engaged in practice at the time of the revision were recognized and registered as "public accountants", but the revised Act closed the door to future registrations and also limited practice thereafter to those holding C.P.A. certificates and those registered as public accountants. Thus the uncertified practitioner became what we call a "dying class" and the way was cleared for ultimate restriction of practice to those holding C.P.A. certificates. Hence, while Virginia presently has two-class legislation, this legislation will in time become one-class legislation.

At the time of the revision, about sixty practitioners were registered as public accountants. Since then, many of these have passed the examination and become certified, some have died, and others have retired from practice, so that at the present time only a few public accountants are registered and practising. Virginia, therefore, is approaching the time when all of its practitioners will be C.P.A.s.

So much for the difference generally between certified public accountants and public accountants, except to say that some States recognize public accountants as a continuing class.

For several years the examination has been uniform in all but one of the fifty-odd State and other jurisdictions and is taken at the same time in each of these jurisdictions. The one State which holds its own examination has been unable to adopt the uniform examination because of a difficulty presented by this State's accountancy law. It is expected, however, that this difficulty will be overcome shortly and that this State will adopt the uniform examination, so making its use universal.

It should be pointed out, however, that since public practice of accounting is regulated by State law, each State, the District of Columbia, and each of the territories and insular possessions has its own Board of Accountancy and the decision of each of these boards is final as to whether a candidate who appears before it satisfactorily passes the examination that he or she takes, subject to appeal, in some States, to the courts of those States. The uniform examination is prepared under the direction of the Board of Examiners of the American Institute of Accountants, and is held in each of the fifty-odd jurisdictions in the fall and in some of them also in the spring. In general, each applicant for the C.P.A. certificate files with the Board of Accountancy of the jurisdiction in which he resides, but the laws of some States permit examination and certification of applicants from other States.

History and Growth of the Profession

As is generally known, the origin of public accounting in the United States was British. The investment of British

funds in American enterprise was considerable in the last half of the nineteenth century and the British practitioners followed British capital. This, together with the obviously favourable outlook for accounting practice in the States, naturally led to the establishment of offices in the United States by the leading British firms.

However, it was not long before our own people began to develop an interest in practice and to establish offices, and in 1896 the legislature of the State of New York enacted the first accountancy law. Schools for the giving of courses in accounting soon came into being, the teaching of accounting quickly developed into quite a profession itself, and one by one the State legislatures enacted accountancy laws. By 1921 such laws had been enacted by all the States. However, as recently as 1920 there were only 5,000 certified public accountants in the entire country. But from that point on the number increased rapidly. By 1940 there were 17,500. By 1948 there were 35,000. Today there are close to 42,000.

Organization of the Profession

The organization of the profession starts at the State level, each State having its own State society, institute or association; in recent years many of the State organizations have also organized local chapters. To illustrate, the Virginia Society of Public Accountants has chapters at Richmond, the capital city of the Commonwealth; in the Arlington-Alexandria area, across the river from the nation's capital; in the Hampton Roads area, embracing the cities of Norfolk, Portsmouth and Newport News; in the south-western part of the State, with headquarters at Roanoke; and in the upper Piedmont section, at Charlottesville.

The membership of the State Societies varies from less than a hundred in the States of relatively small population to several thousand in the States having large populations. The New York State Society, for instance, has more than 6,000 members.

Nationally, the organization of the profession follows to some extent the pattern of the organization of the government of the United States, in that each of the State organizations is autonomous. The American Institute of Accountants, which is the national organization, cooperates closely with the State organizations and maintains continuous liaison with them, but it does not attempt to control them. In other words, the State organizations as such are not members of the Institute. Indeed, not all of their members are. Membership in the American Institute and the State Societies is open only to individuals.

In general, membership in the American Institute of Accountants is open to all holders of C.P.A. certificates who are in good standing in their respective States. The Institute is governed by a Council consisting of 72 members chosen from the States generally on the basis of the distribution of the Institute's membership; nine members at large; the past-presidents of the American Association of Public Accountants (which was the former name of the American Institute); the past-presidents of the American Society of Certified Public Accountants (which merged with the American Institute in 1936); and the presidents of the State Societies. The Council holds an annual meeting and a spring meeting, the annual meeting at the same time as the annual membership meeting, and the spring meeting usually in late April or early May.

To facilitate the work of the Council, there is an Executive Committee which consists of the officers — president, four

vice-presidents and treasurer — and seven members of the Council. The Executive Committee meets as often as the volume or urgency of matters calling for its attention requires. Usually there are five or six meetings a year.

The membership of the American Institute at present is just a little short of 19,000, and because of the Institute's over-all representation of the profession and its consequent ability to finance the greatest possible scope of activities, it has taken the lead in dealing with matters which, for the sake of uniformity, or for other reasons, can be best dealt with at the national level, such as research; formalization of accounting and auditing procedures; public relations; co-operation with bankers, lawyers and the Securities and Exchange Commission; and the role of the certified public accountant in federal taxation and national defence. That is not to say that important and effective activity is not engaged in with respect to these matters by the State Societies. A number of the State Societies do, in fact, engage in activities which are closely parallel to those of the American Institute.

Then, as previously indicated, the role of the American Institute in the matter of developing and making available the uniform examinations, and in grading the candidates papers when requested to do so, is of itself a major undertaking. This work is carried on under the direction of a group known as the Board of Examiners and involves the employment of a staff of considerable proportions.

The American Institute also concerns itself extensively with the matter of education for the profession, and in this field not only combines with the teachers of accounting and their respective institutions to improve the choice of academic subject-matter and the organization of courses, but also seeks to develop positive means of identifying the outstanding characteristics of accountants and discovering those who have these characteristics, and of checking the progress of students and helping them find satisfactory employment upon completion of their studies. The program of finding positive tests of accounting aptitude, checking the progress of students, and finding employment for graduates has been intensively carried out and has resulted in great benefit to the profession as well as to students.

The American Institute is mindful that since membership in it is individual, it has a clear obligation to do whatever it can to improve the material status of its individual members. In pursuance of this obligation, the Institute has made available to its members opportunity to participate in a group insurance plan, under which coverage is available up to the amount of $10,000. This opportunity is extended not only to the Institute's members but also to its members' employees, even those who may not be members of the Institute. At the end of 1951 a total of 1,232 firms were participating in this plan with 8,031 persons covered and $41,606,000 of insurance in force.

Other Organizations

In addition to the American Institute of Accountants, there are other organizations which provide focal points of activity for accountants not engaged in public practice, although the membership of each of these organizations includes many public practitioners. Without any implication as to relative rank, these organizations are: American Accounting Association, Controllers' Institute of America, National Association of Cost Accountants.

The American Accounting Association is the national organization of teachers of accounting.

The Controllers' Institute of America is the national organization of the controllers and finance officers of the nation's enterprises.

The National Association of Cost Accountants is the national organization of cost accountants and those who are primarily interested in cost accounting.

Both the Controllers' Institute of America and the National Association of Cost Accountants have great numbers of local chapters which, in each case, are directly affiliated with the national organization.

At the end of 1951, the approximate memberships of these three organizations were: American Accounting Association, 4,000; Controllers' Institute of America, 3,600; National Association of Cost Accountants, 25,000.

Education for the Profession

In the early days of the profession in the U.S.A., the principal source of education for the profession seems to have been the correspondence school: that is, the school which operates from a central location, enrols students throughout the country, distributes its text material to its students by mail, requires the students to submit written examinations, and grades the papers submitted at the central headquarters. These schools have made a great contribution to the advancement of the profession.

Later the colleges and universities put in courses, often, in the early days, integrating these courses with their schools of economics, though sometimes integrating them with their schools of liberal arts. More recently, there has been a strong trend at the college and university level toward the establishment of schools of business administration and the integration of instruction in accounting with these schools. There already are many such schools.

In recent years, based upon the theory that modern conditions require that an accountant should have something more than a mere vocational education, there has been a strong trend toward the requirement that accounting students precede their specialized study of accounting with some period of basic instruction in the liberal arts, usually for two years. This theory has much to recommend it and it has strong advocates.

If I were to hazard a guess, I would say that this pattern of preparation will in time become the prevailing one. At any rate, from my own observations and experience with staff personnel, and judging from opinions expressed to me by many of my colleagues, I would say that the beginner in the profession who based his study of accounting and related subjects upon a foundation of at least two years of liberal arts education comes to the profession with superior preparation. Such an entrant has the best chance of progressing rapidly and of developing the comprehensive understanding of economic affairs which is rapidly coming to be expected of professional practitioners.

I have no exact data on the subject, but a very large proportion of the colleges and universities of the country now offer varying degrees of instruction appropriate for those who desire to make a career of accounting.

Following World War II, the country embarked upon an extensive program of education for ex-servicemen, and some idea of the popularity of business administration and accounting can be gained from the fact that I am told that the number of G.I.s who enrolled as business administration and accounting students was greater than the number enrolled for any other course. One would have thought that this would have flooded the accounting profession with a surplus of talent, but it didn't. The G.I.

program has about run out, but in spite of the number of accounting graduates turned out under this program, and in spite of the fact that the business and accounting schools still are experiencing heavy enrolments, there continues to be a very considerable shortage of personnel trained for the profession. This condition undoubtedly is largely attributable to the high level of economic activity which has resulted from the current defence program, but the demand for accounting personnel continues to grow, and the time when balance between demand and supply will be reached is not yet in sight.

Factors Contributing to the Growth of Public Accounting Practice

Public practitioners and laymen alike are inclined to ascribe the growth of public accounting practice largely to adoption by the U.S.A. of income tax legislation. The first federal tax based upon income was passed in 1909, but we did not get down to income taxation in its present form until March 1, 1913. It cannot be denied that the adoption of the income-tax and the almost annual extension of the base of this tax created expanding demand for accounting services, and it is a fact, of course, that a good portion of every practitioner's time is devoted to engagements directly or indirectly related to the income tax. However, I think that the influence of this tax has been greatly overstated.

It is my opinion that fundamentally the profession's almost phenomenal growth has been due to the intensive development of natural resources and the equally intensive extension of industrial activity which has characterized the economy of my country, especially since the turn of the century. It seems to me that this becomes crystal clear when one stops to recall the number of our major industries which have come into being during the last 40 years and the proportions of the contribution of these industries to our gross national product.

These industries include such giants as electric power; electrical equipment and appliances; the automobile; truck transportation; radio; industrial chemistry; plastics; rayon; motion pictures; the aeroplane; air transportation; frozen food; television; and synthetic rubber — not to mention the enormous expansion that has taken place in the production of metals, notably steel, copper, and aluminium. A good idea of the country's industrial growth can be obtained from the fact that its productive capacity has been far more than doubled since 1939. It was increased about 90% in the three-year period from 1949 to 1951 alone.

The automobile industry alone directly and indirectly affords employment to 9 million workers, or about one-seventh of the country's entire labour force. The trucking industry, which carries 80% of all the country's inter-state passengers, transports more than 50% of all workers to their jobs, carries 90% of all the nation's food to market, and hauls 75% of all general freight, employs more people than all other forms of transportation combined.

Fundamentally, therefore, while such developments as income taxation, bankruptcy legislation, the control of security exchanges and the issuing of securities, the regulation of public utility rates, and economic controls generally, each has created a large demand for accounting services, the main driving force behind the growth of the accounting profession undoubtedly has been the unparalleled expansion of industry.

The backlog of every practitioner's concern is auditing of the books of the country's enterprises and institutions. This is heavily supplemented by tax practice and by engagements involving the installation or revision of accounting sys-

tems and procedures. I would say, however, that these other engagements, though many of them are highly important and call for the very highest level of technical judgment and skill, still rank second, even in the aggregate, to auditing.

There has been a recent development, however, that should not be overlooked. The growing complexity of our economic structure, and the burden of complying with an ever-increasing number of government regulations designed to control economic activity, and the exceptional manner in which the public practitioner has met the challenges of practice, naturally have caused clients to look to their certified public accountants for assistance in solving a growing list of problems not originally deemed to be within the scope of the public practitioner's training and experience.

Over the years, business management has found it increasingly difficult to keep costs and expenses down to the point where there would be a reasonable return on investment after the payment of taxes. More and more management has turned to the certified public accountant for help in meeting this problem. As a consequence, many accounting firms have established divisions of their practices to render this kind of service; and be it said to their credit that they have in many situations distinguished themselves highly in this field.

This development is growing and undoubtedly will grow to larger and larger proportions as the years go by, and the certified public accountant will find himself not only an accountant and auditor but also something akin to a business doctor. This is inevitable, because it is a natural evolution. The constantly broadening base of the public practitioner's academic training and experience make it so.

Literature of the Profession

The most widely distributed publication of the profession is *The Journal of Accountancy,* which is published by the American Institute of Accountants. Its present circulation is approximately 67,-500. It goes to every member of the American Institute as a part of his membership fee. Thus you will see that there is a circulation of close to 50,000 among others. The other subscribers include, for the most part, business executives, treasurers, controllers and educators.

The American Institute also sponsors from time to time books and other publications on various phases of accounting, one of the most widely circulated of which is the annual publication entitled *Accounting Trends and Techniques.* This is an annual survey by the Institute's Research Department of the published annual reports of corporations. In it are particularly analyzed and reported the handling of various elements of corporate financial statements, thus pointing up what is being done in practice about the problems of accounting with which business and the profession, particularly the Institute's Committee on Accounting Procedure and Auditing Procedure, are especially concerned.

Specific technical problems are dealt with from time to time by the Institute's Committee on Accounting Procedure and its Committee on Auditing Procedure. After being thoroughly discussed and reviewed, not only by the respective Institute committees but also by other interested parties and organizations, these problems are reported in the form of Accounting Research Bulletins by the Committee on Accounting Procedure and in the form of Statements on Auditing Procedure by the Committee on Auditing Procedure. Up to this time, 41 Accounting Research Bulletins and 24 Statements of Auditing Procedure have been issued. These statements and bulletins go to all members of the American Institute without charge and are available to other interested persons at nominal prices.

At the moment, the American Institute is engaged in the writing and compiling of what will be called the *Manual of Accounting Practice*. This is perhaps the most ambitious single publication yet undertaken by the Institute and will provide for its members information written by carefully chosen authors concerning every phase of public practice. It undoubtedly will constitute the most valuable of all the many aids to its members that the Institute thus far has developed.

In addition to the publications of the Institute, many of the State Societies publish monthly or quarterly reviews of accounting papers and, of course, a great many original papers as well.

Another valuable publication is *The Accounting Review,* which is published monthly by the American Accounting Association. This publication is turned out primarily for the benefit of that Association's members, many of whom are members of the American Institute of Accountants, but, like *The Journal of Accountancy,* it also enjoys substantial circulation among business executives, treasurers, controllers and others.

Further, both the Controllers' Institute of America and the National Association of Cost Accountants put out regular publications dealing primarily with matters of particular interest to their members, many of whom, again, are members of the American Institute of Accountants. Finally, never a month goes by without independently published books on some phase of accounting, auditing, taxes, and other subjects of interest to the profession. Altogether, therefore, the literature of the profession in the U.S.A. is prodigious.

Staff Training

There has not been, so far as I know, any nation-wide, or even any statewide, survey and report on the extent to which staff training is conducted, the kind of training given and the manner in which it is given. However, I have discussed this problem with a great many of my colleagues, and I believe that I can make a fairly accurate statement concerning it.

First, I would say that there is hardly a practitioner in my country who does not recognize the need for staff training, not only as affording the best assurance of establishing and maintaining the highest possible level of competence but also, particularly at this time, as the best possible means of getting beginners up to an adequate level of earnings as rapidly as possible. This is especially important right now, because public practice has been traditionally the training camp from which private industry has drawn much of its accounting personnel. With taxes at their present levels, with the supply of accounting personnel almost acutely short of demand and with salaries subject to strict control, the public accounting profession recently has become the victim of extensive pirating of its personnel by private industry.

Notwithstanding the fact that beginners generally now start in the profession with increasingly better academic training, everyone agrees, including the educators, that there is no substitute for experience. Even the best apprenticeship training during the course of a student's academic work (which is being tried with varying degrees of success, but which is growing) is not now, and is not likely to become, a complete substitute for experience. Consequently, the progressive firm must do everything practicable to hasten acquisition of experience by its junior staff members. Staff training, therefore, is essentially an effort to accelerate the beginner's progress.

Such training varies all the way from relying upon juniors to get the most out of the engagements to which they are assigned, supplemented by study of current papers and articles, to carefully

conceived programs of study and instruction.

For obvious reasons, the extent of in-service training usually is in proportion to the size of the practice enjoyed by the beginner's employer or employers and to his employer's attitude concerning his or their responsibility for the progress of staff members. Some firms, particularly the larger ones, give the instruction themselves. Others arrange to have their staff members attend available extra-curricular classes. Still others, of course, do nothing at all. Some of the larger firms go so far as to put a beginner, regardless of his academic training, through a considerable period of instruction before he is assigned to his first engagement.

There is no question but that staff training is destined, probably very soon, to be extended far beyond its present proportions. In my opinion, this is going to be necessary if the growing firms are to have any hope of keeping the sizes of their staffs equal to the demand for their services. Indeed, I will go even further and venture the opinion that if this is not done, if beginners are not more quickly brought to the point where higher charges can be made for their time and skill, with consequent acceleration of salary increases, the time soon will come, if our economy continues to expand as it has in recent years, when there will not be any but partners left to render the services required by the profession's clients. If this happens, reduction in the size of some firms and increase in the number of so-called small practitioners will be inevitable.

Personally, I should regard this eventuality as being not only unfortunate but also highly undesirable from the standpoints of clients, practitioners and staff members, all three, for the simple reason that the present demand for the services of public accounting firms is so varied that it is next to impossible for an individual practitioner without a fairly numerous staff to render satisfactorily all the different kinds of services now expected of certified public accountants. I do not think it would be good for the profession, for those who require the profession's services, or for staff members, for practice to become highly specialized. I believe that if this happens we would find ourselves in the position that the medical profession has reached in the U.S., where the gradual disappearance of the general practitioner is regarded as a serious problem.

This is not to say that a certain amount of specialization is not desirable, for such a position could not be justified. However, there is such a thing as over-specialization, and in my opinion that is more undesirable than no specialization at all.

Professional Ethics

The recognized authority on ethics in the public accounting profession in the United States is the Executive Director of the American Institute of Accountants, Mr. John L. Carey. In 1946, the American Institute published a book on ethics written by Mr. Carey and entitled *Professional Ethics of Public Accounting.* Prior to and since that time, Mr. Carey has spoken extensively on ethics. Mr. Carey believes, as I do, that no profession in our country has a higher code of ethics than the public accounting profession and that the members of no profession are more faithful in their compliance with the rules that they voluntarily have adopted to control their conduct towards the public and themselves.

In a paper read at the Second Inter-American Accounting Conference at Mexico City in November, 1951, Mr. Carey classified and reviewed the rules of ethics that generally prevail in the United States. In this address Mr. Carey

divided the rules of ethics into three categories: first, those that are designed to assure and preserve independence and impartiality on the part of the public practitioners; second, those that are designed to safeguard the legitimate interests of clients of the profession; and, third, those that are designed to guide the members of the profession in their relations with each other.

As to the first category, Mr. Carey said:

> . . . the most important rule in a code of ethics for the public accounting profession should be a rule that serves as a guide to right action to the professional accountant in preserving his independence and impartiality and at the same time as a declaration to the public that he will not place himself in positions in which his independence is liable to be impaired.
>
> Such a rule may be broken down into several parts covering the following points:
>
> (1) The professional accountant acting as an independent auditor accepts the obligation of maintaining independent and impartial judgment in his examination of accounts and in expressing his opinion on financial statements.
>
> (2) He will disclose all material facts which he discovers that have a bearing on the financial position or the results of operations.
>
> (3) He will conduct his examination of accounts in accordance with generally accepted auditing procedures and not express an opinion on financial statements unless he has made an adequate examination.
>
> (4) He will not have any substantial financial interest in the affairs of a company on whose financial statements he is reporting without fully disclosing that interest.
>
> (5) He will not render an opinion on financial statements under circumstances in which the amount of his fee depends on the successful outcome of any venture in which those financial statements may play a part, such as the issuance of securities.
>
> (6) He will not engage in any other occupation simultaneously with the practice of public accounting which might impair his impartiality or objectivity in reporting on financial statements.

As to the second category, Mr. Carey said:

> . . . the second most important rule of a code of professional ethics for the accounting profession is a rule designed to safeguard the legitimate interests of clients of members of the profession.
>
> This rule may be broken down into parts to cover the following points:
>
> (1) A practitioner will not violate the confidential relationship between himself and his client.
>
> (2) He will not exploit his professional relationship with the client by accepting commissions, brokerages or other compensation from suppliers whose products or services he may influence the client to purchase.
>
> (3) He will not seek to shield himself behind the corporate form of organization, but will conduct his practice as an individual or member of a partnership.
>
> (4) He will not allow others to practise in his name unless they are in partnership with him or in his employ as an accredited member of the profession and thus subject to his control and supervision. Likewise, he will not sign his name to reports on financial statements which have been prepared by others who are not in his employ or in partnership with him or who, as his representative, are not accredited members of his profession who accept responsibility to him.

As to the third category, Mr. Carey said:

> . . . the third most important rule in a

code of professional ethics for the public accounting profession is a rule to serve as a guide to right action in relations of the practitioner with his colleagues and with his profession as a whole.

Such a rule might be broken into parts covering the following points:

(1) The professional public accountant will not advertise his professional attainments or services, except as appropriate announcements may be permitted by the rules of his society.

(2) He will not solicit the clients or encroach upon the practice of another professional accountant, although he may properly respond to any request for service and advice which comes without solicitation.

(3) He shall not offer employment to an employee of another public accountant without first informing that accountant, although he may properly employ anyone who of his own initiative applies for such employment.

Mr. Carey then pointed out that his paper was not intended as an outline of "a complete code of professional ethics for the accounting profession, but only to suggest the fundamental rules which it is believed should be an essential part of any such code. There are many other aspects of professional accounting practice on which rules or precepts might usefully be written, but the ones mentioned here, in my opinion, are basic and indispensable".

Finally, Mr. Carey concluded: "All the points I have mentioned in this paper are now covered, explicitly or implicitly, in the rules of the American Institute as well as some other points which do not seem sufficiently fundamental to warrant consideration at this time", reminding his audience that "these rules were not all put into effect at one time but have been developed over a long period of time out of the experience of the membership", and suggesting the certainty that "they will undoubtedly be modified and elaborated further in the future as additional experience may indicate desirable changes".

Such rules have been adopted by all the State societies, institutes and associations. In some States, the rules of professional ethics have been written into the accountancy laws, either specifically or by reference.

The American Institute enforces its rules continually through its Committee on Professional Ethics, which receives and considers complaints of violations and refers to a trial board those complaints that require disciplinary action. The trial board may admonish, suspend or expel a member who is found guilty after a hearing of the charges made against him. Somewhat the same procedure is followed in one form or another by the State organizations.

Some Current Problems

This paper would not be complete without some reference to at least two problems that currently confront the profession in the United States: first, the question whether it is desirable to define accounting practice; and second, the question whether those who do not intend to engage in the practice of public accounting should be given C.P.A. certificates.

The first of these questions has been plaguing the profession for years. The second is only beginning to emerge. As to each of them, I desire to make it clear that what I shall say concerning it must be regarded as indicating my own thoughts alone and should not be regarded as indicative of any opinion or conclusion by the American Institute or of any State organization.

For several years, there has been a growing insistence by certain members of

the Bar that certified public accountants, in their practice, particularly in their handling of tax matters, frequently get over into the realm of the lawyer. Some of these gentlemen even go so far as to take the position that certified public accountants are practising law when they do no more than prepare a tax return, and the American Bar Association itself, and some of the State Bar Associations, have, through their Committees on Unauthorized Practice of the Law, sought to exclude the certified public accountants from tax practice in one degree or another. Recently, however, the two professions have agreed upon a tentative statement on this troublesome question through a group consisting of representatives of both professions and known as the National Conference of Lawyers and Certified Public Accountants.

I do not intend to discuss the position taken by the lawyers. I must admit, however, that on occasion, and in varying degrees, members of the accounting profession undoubtedly have strayed over into the lawyers' field. However, I hasten to point out that I have never heard of a single case where the transgression was deliberate and intentional: in every case the accountant has averred (honestly, I believe) that he did not intend to invade the lawyers' province and would be especially careful to avoid repetition of the offence.

The difficulty up to this time has been that the accountants have always been on the receiving end of the complaints, whereas it is perfectly obvious that lawyers frequently invade the province of the certified public accountant. Moreover, lawyers not infrequently (especially where they act as secretary, director or in other close relationships to business enterprises) seek to impose views, not to say orders on occasion, upon the certified public accountant which, if yielded to, would make the certified public accountant guilty of utter and complete violation of his obligation of independence.

It may well be that this problem can be worked out by negotiation, but the lawyers are numerous in our country; it is well known that they are in control of the Congress and practically all State and local legislative bodies. It is entirely possible, therefore, that the lawyers' infringements upon the province of the certified public accountants cannot be solved except by including in the State accountancy laws some definition of what constitutes the practice of accounting, although, recognizing that the lawyers are in virtual control of our legislative bodies, this obviously might be a very difficult, if not impossible undertaking.

However, it is my opinion that if the problem cannot be solved by negotiation, then public interest demands that an effort be made to settle it by legislation. At any rate, I am not willing to concede that the lawyers are Simon Pures and that the accountants alone are sinners, and I think that the accounting profession is too grown-up, and the essentiality of its position in the scheme of things is too well recognized, to warrant its members' allowing it to be picked on, bullied, pushed around and interdicted by another group, no matter how exalted that group may be or in what esteem it may be held by itself and others, including the members of the public accounting profession — and I assure you that we of the public accounting profession yield to no one in our admiration of and respect for our brothers of the Bar individually and as members of a great and most useful profession.

The probable need for defining what constitutes the practice of accounting is not suggested by the encroachment of the lawyers alone, however. We have another group in our country, generally described as public bookkeepers, who are not subject to regulation, though there is

no good reason why they should be. This group frequently gets over the line into accounting practice, and sometimes with tragic results. For instance, I have seen numerous cases where business people have got into serious financial difficulties, and into such difficulties with the tax authorities as to cause these authorities to assert fraud, because some fellow who fancied himself to be an accountant gave faulty advice as to how books should be kept.

Considering the importance that accounting assumes in a society that is so highly industrialized as that of the United States, it seems to me that the giving of advice as to how accounts should be kept is an activity which, like the independence and impartiality of the certified public accountant, acting in the capacity of auditor, is affected with the public interest. I am inclined to believe, therefore, that the time has come for us to insist that the right to give such advice be limited to those who have proven themselves qualified by training and experience to give it.

The question whether C.P.A. certificates should be issued to those who do not intend to follow public accounting as a career is beset with difficulties of equal magnitude, although I do not believe that these difficulties are insurmountable.

The principal difficulty lies in the question what is to be done about those who become certified public accountants and later leave the profession to accept other employment. I would not be so foolish or so unfair as to suggest that in such cases the C.P.A. certificate should be recalled. I do suggest, however, that perhaps the granting of C.P.A. certificates should be conditioned upon demonstration of sincere intention to follow public accounting as a career. It may well be that what I have in mind as a demonstration of this sincerity will not work out in practice, but I believe it will. In any event, I think that the time has come for serious consideration of the problem.

Most of our State laws are founded upon the theory that C.P.A. certificates should not be granted until those who apply for them have acquired some amount of experience, usually from two to three years, on the staff of a C.P.A. or firm of C.P.A.s. But there are many who feel — and this is true of the members of many State Legislatures — that anyone who completes a satisfactory course of academic instruction and is of good character should be permitted to take the examination and be given a certificate if he passes. In fact, there are some States that do not impose any experience requirement, and that is exactly what happens in those States.

Based upon my observations and experience over 35 years of practice, I think that this is an utterly fallacious view. My own proposition is that anyone of good character who is academically qualified to take the examination should be permitted to do so and that his papers should be graded without regard to whether he has had experience or not. However, I would withhold the issuing of the C.P.A. certificate where the examinee had not had any experience until such time as he gains it, and I would recognize only experience gained under the direction of a C.P.A. or firm of C.P.A.s.

Just how much experience one should have before receiving the certificate need not be discussed at this time. I would say, however, that it ought to be a minimum of three years and perhaps as much as five years, since under such a policy as I have suggested the waiting period ought to be sufficient not only to assure the acquisition of requisite experience, but also sufficient to give reasonable assurance of the applicant's in-

tention to make public accounting his career.

Under the plan that I propose for consideration, a person who successfully passes the examination and completes the required number of years of experience would be deemed to have demonstrated intention to make public accounting his career and would be given his certificate regardless of whether or not he continues in the accounting profession thereafter.

The C.P.A. certificate was originally conceived as an attestation of fitness to engage in the *public* practice of accounting, and the reasons for this distinction are more compelling to-day than ever. Those accountants who do not choose to go into public practice do not need C.P.A. certificates, and it is a distortion of the purpose of the accounting laws to give them certificates. I know of no surer way to make certain that the designation certified *public* accountant means what it clearly implies than to make the C.P.A. certificate available only to those who demonstrate that they intend to make their careers in public practice.

Conclusion

The outline that was sent to me as a guide for this paper indicated that my subject was to be "The Accountant in Practice and Public Service". I have not dealt with the accountant in public service, because that is a separate subject in itself and the problems of governmental accounting are quite different from those encountered by the professional public accountant. True enough, governmental accounting involves the application of special techniques and procedures, but in this respect governmental accounting is no different from many categories of enterprise accounting.

I might say, however, that tremendous advances have been made in governmental accounting in my country during the the past 25 years, and I think that the professional accountants can claim a great deal of the credit for this, because undeniably it has been the progress of accounting generally that has forced improvement in governmental accounting, and much of this progress has been wrought by professional public accountants who have either temporarily or permanently entered the public service to apply the techniques and procedures that they learned and helped develop in the course of their professional practices.

For instance, our national government has made tremendous improvement in its accounting, especially since World War II, and the leadership in this improvement has been, and is being, furnished without exception by men recruited from the public accounting profession.

Observations on the Decision In Capital Transit Limited v. M.N.R.

By J. E. Smyth, C.A.

Professor Smyth points out the startling implications of this disturbing decision

THE decision in the recent *Capital Transit Limited*[1] case is an eloquent plea for a wider understanding of accounting concepts outside the accounting profession. The main thesis of this memorandum is that the decision was based substantially upon a misinterpretation of the accounting term "revenue". Before we proceed further, therefore, we must first agree upon some definition of revenue for the purpose of this discussion. The following seems to embody the accountant's idea of revenue:

Revenue is the measure of the flow of assets into a business in return for goods sold or services rendered.

Some accountants may prefer the term "gross income", but no matter. In any event the Income Tax Appeal Board does not appear to have been aware of this fundamental accounting concept because in the present case it disregarded the latter part of the definition ("in return for goods sold or services rendered"). When this part of the definition is omitted we have then a proposition which is a travesty of accounting thought: *revenue means receipts.*

In passing, before we throw up our hands in horror at the thought that any court could believe such a thing, we might first ask ourselves whether we, as members of the accounting profession, have, through published discussion of accounting terminology, driven home the elementary accounting concepts often enough, clearly enough, emphatically enough. Because we cannot agree upon some word or minor phrase in a definition we have no recognized definitions; and then we have a result like the one in the present case. It is clearly not sufficient for us to say that these basic concepts are "in our minds", and then to complain that the courts are "out of touch with the accounting idiom". Like Mr. Pim, the accountant should say, "I blame myself, I blame myself."

The Facts in the Case

The facts of the *Capital Transit Limited* case were substantially these: Capital Transit Limited operated a bus line and on its records credited the proceeds of ticket sales to a liability account, "Tickets Outstanding" (the debit being to general bank account). When the tickets were subsequently used by the purchaser, "Tickets Outstanding" was debited and "Passenger Revenue" credited. Some tickets might not be used, but refunded,

[1] An abridgment of this case will be found at [1952] Tax Rev. 213

in which case "Tickets Outstanding" would be debited and "General Bank" credited.

Over the period 1945-1949 each successive year end balance in "Tickets Outstanding" account was greater than at the year end preceding. The Minister, in each of the four years 1946, 1947, 1948, and 1949 assessed Capital Transit Limited for additional taxable income in the amount of the increase in the balance in "Tickets Outstanding" over the year. This amounted to saying that money received from the sale of tickets by a bus company is revenue for the year in which received in spite of the fact that some of the tickets are not honoured in that period for either transportation or refund. In his decision Mr. W. S. Fisher, Q.C. of the Income Tax Appeal Board substantially confirmed the assessment.

Mr. Fisher said, "I am of the opinion that, under the law as it now stands, the appellant is required to report, as part of its income for tax purposes, the total amount of the cash received by it upon the sale of its bus transportation tickets as and when the cash is actually received and not merely when a portion or the whole of the ticket is used. I feel, however, that the appellant should be entitled to deduct from such gross income the expenditures which it will be required to make to earn the profit inherent in such gross income. Nevertheless, I am faced with the provisions of paragraph (d) of subsection (1) of section 6 of the *Income War Tax Act* and paragraph (e) of subsection (1) of section 12 of the *Income Tax Act* which prohibit a deduction in respect of a reserve or a contingent account."

Judgment Analyzed

The reasoning behind this ruling may be divided into two main parts as follows:

Part I

(1) Revenue means receipts.

(2) Therefore, revenue includes receipts from the sale of services to be rendered in the future.

Part II

(1) Equity requires that the cost of obtaining the receipts be allowed as a deduction in computing taxable income.

(2) But the cost of obtaining receipts for which services have not yet been rendered is a cost not yet incurred, and to provide for that cost would require the creation of a reserve.

(3) The only deductions from revenue permitted by the Act which have the effect of increasing reserves are for bad debts, depletion, and depreciation.

Conclusion

Therefore the taxpayer must include in his taxable income all receipts relating to the sale of future services.

Surely the validity of this whole chain of reasoning depends entirely upon the major premise, that revenue means receipts. Nevertheless the case is argued not in terms of Part I (which appears to be taken for granted) but in terms of Part II.

The point is that "Part II" of the reasoning has no meaning whatever, and is irrelevant, if "Part I" is false.

Is the Law at Fault?

The Board expressed the view that, while its decision might appear inequitable, the remedy lay not with it but with Parliament by way of amending the *Income Tax Act*. This establishes the Board's preoccupation with the reasoning which I have called "Part II". But Part I is the Board's responsibility. There appears to be nothing in the Act to qualify the definition of revenue submitted

at the beginning of this memorandum. Perhaps, however, the only way we will convince the Courts of this is to have a positive definition of revenue inserted in the Act!

This is not by any means the first time a legal decision has been rendered along these lines. In an article in *The Journal of Accountancy* for December 1938[2] James L. Dohr referred to a number of analogous decisions. He mentioned, among others, a ruling of the U.S. Bureau of Internal Revenue to the effect that a publisher who collects long term subscriptions in advance is taxable on the full amount of such subscriptions *as received* without any allowance for his legal obligation to fulfil his agreement; i.e. to buy paper, print, and deliver his product over a period of years. In the same article Mr. Dohr noted, most pertinently, that "the question is not one of a *deduction* in the computation of income but rather one involving the receipt of property which could not be income in its entirety, because its receipt was accompanied by a legal obligation; that the receipt was, in part at least, what the accountant calls 'unearned' ".

In a dissenting opinion in a somewhat similar U.S. case[3] Mr. Justice McReynolds said that, "Divorced from reality, taxation becomes sheer oppression."

What is a Liability?

There are a number of ancillary points raised in the *Capital Transit Limited* decision that merit discussion. Mr. Fisher, in giving the opinion of the Board, said, "[The appellant] has set up in its balance sheet the total amount of cash representing outstanding tickets at the end of its fiscal period as a liability. In other words, it has estimated that it may possibly have to refund the whole amount of the cash value of the tickets shown in its account to be outstanding."

This part of the decision appears to overlook the fact that a liability may be *a liability to render future services,* not a liability to repay money. Perhaps this goes to the heart of the problem. The receipt of money is not revenue to the extent that the receipt creates a liability.

In referring to the earlier decision of the Exchequer Court in *Robertson* v. *M.N.R.* [1944] Ex. C.R. 170[4] Mr. Fisher appeared to take the view that only receipts held by way of trust may be excluded from the calculation of income. He said, "The moneys received for the ticket by the appellant herein become its sole property, to do with as it sees fit, immediately after receipt, and the purchaser of the ticket has no control or interest in the moneys so paid to the company. In other words, the moneys are not held in trust by the company on behalf of the purchaser until the purchaser has presented his ticket to the company for transportation. The presentation of a ticket for refund when it is not used by the purchaser is an abnormal situation . . ."

Startling Implications

This seems to contain some rather startling implications. Are, for example, the deposits received by a bank held in trust for customers or does the bank do as it sees fit with the moneys received? Surely this is not the criterion for deciding whether moneys received should be included in taxable income. Or, returning to the case of a commercial or industrial concern, does the Board suppose that the proceeds of a bank loan are part of the taxable income of the borrower merely because he does not keep the proceeds

[2] James L. Dohr: "Income Divorced from Reality", *The Journal of Accountancy,* Dec. 1938, Vol. 66

[3] *Helvering* v. *Mutual Life Insurance Co.* cited by J. L. Dohr, *ibid*, p. 370

[4] See analysis of this case at [1952] Tax Rev. 116

continuously earmarked and ready for repayment?

Mr. Fisher pointed out elsewhere in his decision that some part (admittedly a very small part in all probability) of the moneys received would never be recorded as income because some tickets might never be used or presented for refund. The writer leaves it to more competent readers than he to speculate whether from a tax point of view this windfall is a gift or taxable income!

In any case the treatment of tickets lost, destroyed, or forgotten about by the purchaser is a separate accounting problem. If at a year end any significant part of the balance in "Tickets Outstanding" account is represented by tickets that will never be presented for transportation or refund, good accounting practice would support a transfer of the price paid for these tickets from "Tickets Outstanding" to profit and loss account.

A Serious Problem

The serious nature of the problem raised by legal decisions that are out of touch with accounting thought was summed up in strong language by Mr. A. A. Berle Jr. (himself a lawyer) in an address to the American Accounting Association in 1937. Mr. Berle said, "The only places where the United States Supreme Court can be overruled are the law schools and the law reviews. The only practicable method of checking a foolish or unwise administrative ruling on accounting is in the technical journals and the proceedings of the associations. In the law, we know that the long process of recorded study ultimately serves as a corrective upon the most powerful courts; and the case for that correction is infinitely stronger in a relatively new field like that of accountancy. Wanting the continuous interplay of professional opinion and quasi-legal decision, your profession may well slip into a morass quite as deep as the valley from which it has climbed."[5]

The views expressed in this memorandum are of course personal opinions. I have written these notes because I believe the decision in *Capital Transit Limited* v. *M.N.R.* deserves a great deal of consideration by the accounting profession.

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[5] Cited in an editorial, *The Journal of Accountancy,* December 1938, p. 354

Modern Auditing Techniques

By Frank T. Denis, C.A.

While auditing procedures have changed but little, there have been some striking changes in emphasis

IN RECENT years the accounting profession has been working toward a clarification of its professional responsibilities. Efforts are being directed towards (1) a more precise definition of what are generally accepted accounting principles, (2) the determination of the duties and responsibilities of the independent auditor, (3) the principles which control the scope of his examination and the content of his report and opinion, and (4) the setting of standards of professional conduct. By and large, regardless of the purpose for which an accounting report or statement is prepared, the objective is to produce fair and adequate reporting through financial statements.

With the growth of business enterprises both in size and diversification the function of the auditor in expressing his professional opinion for the benefit of the shareholders who appoint him and for third parties assumes an ever-increasing importance. One of the main justifications for his existence in our economic life is the part he plays in the maintenance of mutual confidence which is necessary in business dealings of today.

In spite of a stock market boom and crash, a depression, a devastating war with consequent plethora of government regulations, and economic adjustments resulting from a changed standard of values — all this over a period of some 25 years — the basis of the duties of the auditor of public companies as set out in the various Companies Acts remains unchanged, although I believe committees are presently engaged in studying revisions of the Dominion *Companies Act.*

Trend in Auditing

What has been the trend in audit procedure and reporting?

The culmination of all the work performed in connection with an audit is the expression of a professional opinion on (a) whether the balance sheet presents a true and correct view of the affairs of the company and (b) whether they are as shown by the books of the company. In September 1951 the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants recommended that when the auditor is reporting upon the financial statements of a limited company

A paper read to the 50th annual meeting of the C.I.C.A., Montreal, Sept. 10, 1952

incorporated under the *Companies Act, 1934* and is in a position to express an unqualified opinion, his report should include the statements of profit and loss and surplus as well as the balance sheet. This recommendation is receiving general support in the profession and in more recent statements the wording of the auditors' report is framed to include these statements. I think it is significant that this extension of responsibility should have come from pressure within the C.I.C.A. rather than to meet a requirement brought on by pressure from outside.

Auditing procedures have not changed notably but there has perhaps been a gradual change in emphasis. While the responsibility of the auditor devolves on the expression of his opinion and is the same whether his client be the shareholders of a large corporation or a small enterprise, the means of arriving at the opinion must of necessity be different. Conditions in the accounting field in the United States are really very similar to ours and we watch with much more than passing interest the literature that emanates from the accounting bodies there. The phases of auditing which have been receiving the most attention in recent years are the procedures in the examination of inventory quantities, the confirmation of accounts receivable, and investigation into the effectiveness of internal control. Of these three phases the system of internal control is the one which particularly interests the auditor. It is the one which will determine the extent to which he will be able to rely on the accuracy of the records, and the amount of test checking he must do in order to be able to substantiate as reasonably as possible his opinion on the statements.

Let me turn for a moment to the British *Companies Act* which was rewritten in 1948. The sections which deal with accounts probably contain for companies the most important amendments under the new law. The Act requires that the auditor pass judgment on whatever proper books of accounts have been kept, and also that the balance sheet gives a true and fair view of the state of the company's affairs, and that the profit and loss account gives a true and fair view of the profit or loss for the year. Every company is obliged to show in the statements the comparative figures from the previous year.

Generally Accepted Auditing Standards

There is, no doubt, a wide scope for discussion as to what constitutes "generally accepted auditing standards". The auditor attempts to summarize the work he has done by reporting that he has received all the information and explanations he has required, and that his examination included a general review of the accounting procedures and such tests of the accounting records as he considered necessary in the circumstances.

There can be no laid down rules as to the minimum or maximum amount of detailed checking which must be done. Even if a system of internal control were judged to be air-tight, it would still be difficult to justify doing no checking at all. On the other hand it is just not practical to conduct a detailed examination of all transactions. The answer is of course that the auditor must do as much as is necessary to arrive at an opinion and issue a report, qualified or otherwise. I cannot help feeling that there is no substitute for good common sense in determining the course the procedures should follow on an engagement.

It is difficult, too, I think, to define just what "generally accepted auditing standards" are. As I see it, they encompass not only the work which is done in the field, but also the degree of in-

telligence with which the information is interpreted. Auditing procedures are so numerous and should be varied to meet circumstances that it is not feasible to enumerate those which would be applicable generally. We should avoid attempting to reduce the examination of accounts to a stereotyped list of instructions which is to be checked off as each operation is completed.

View of American Institute

The American Institute of Accountants in the foreword to its brochures "Case Studies in Auditing Procedure" summarizes the concept of auditing standards as follows:

General Standards:

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of Field Work:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of Reporting:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

I have been unable to find a comparable set of standards for Canadian practice but I think any drawn up would about cover the same requirements.

There are many problems facing the profession today, some more serious than others. I have no doubt most practitioners today are conscious of rising operating costs, particularly as a result of the higher salary levels paid to all staff members right down to the student assistants. Some of this has been absorbed in increased fees, but it would be interesting to know to what degree it has been found practical to offset this factor by modifying the audit program insofar as the amount of detailed checking is concerned. I do not suggest for one minute that the work should be reduced to the point where an auditor might jeopardize the basis for forming his opinion but with the greater diversification of matters with which an average business must deal today, might not the time be spent more beneficially on analytical work than in checking a multitude of vouchers or adding up page after page of the cash book — particularly if it is machine accounting?

Planning an Audit

An audit of any size calls for careful planning. An attempt should be made to allocate time estimates to the

functions which are to be performed. The functions are then divided among classes of personnel, and the supervisor determines the extent to which the procedures must be carried out in order to be adequate as a basis for forming an opinion. Programs, a questionnaire on internal control, a permanent file, and a comprehensive set of working papers are the elements that go to support the auditors' opinion and the competence with which these are prepared is a measure of the trust that can be placed in his report.

How much importance and reliance may be placed on the use of the client's staff? Insofar as an aid to audit procedure is concerned, the functions of the client's own staff can be broken down into two kinds of operations: (1) those relating to internal control in effect and (2) the internal audit staff. Someone has said accounting is constructive whereas auditing is analytical, and I think as applied to two functions I have just mentioned, this is so. The internal control is carried out by accounting personnel. If the system is effective, it can be of considerable value to the auditor. The internal audit staff on the other hand performs a function similar to that of the auditor himself, but serves a different master. Its work is very valuable, but only to the extent that it enables the auditor to form an independent opinion on the accounts. Working jointly with the internal auditor is frequently to the mutual benefit of both and should be encouraged. In many engagements, particularly in the audits of small enterprises, the accountant must often make up for deficiencies of his client's organization. In such instances he finds himself acting in two capacities, first as the accounting adviser in the preparation of the accounts, and as auditor testing the accuracy and credibility of the information so produced. Generally there is no conflict of duty or embarrassment in those functions.

The Cost Element

The Committee on Auditing Procedure of the American Institute of Accounting in its special report on "Tentative Statement of Auditing Standards" has this to say:

> It is doubtful that the failure by an auditor to undertake a required procedure could be excused solely on the ground that "it cost too much". Nevertheless, one of the circumstances which may be justifiably considered in determining required procedures is the economic factor of expense involved, particularly when this factor is properly evaluated in relation to the elements of risk and materiality.

Scope of Examination

To what extent should the auditor require to report on the scope of his examination? It is not so long ago that the standard form of report in common use was a paraphrase of sec. 120 of the Dominion *Companies Act* and said "I have examined the accounts"—and that was about all. Ontario went a little further and said "all my requirements as auditor have been complied with". Contemporary reporting in the United States went considerably further by stating that "we examined or tested accounting records", also "made a general review of the accounting methods but we did not make a detailed audit of the transactions". Then followed, in each instance, the opinion on the statements. Today the auditors' report in each country has been modified. I have already referred to the form recommended by the C.I.C.A. which includes the profit and loss and surplus in the opinion, and we now make reference to the work done: "My examination included a gen-

eral review of accounting procedures and such tests of accounting records and other supporting evidence as I considered necessary in the circumstances." Our friends to the south got around the negative aspect of their report by deleting "but we did not make a detailed audit of the transactions" and substituted therefor: "Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances and included such tests of the accounting records and other supporting evidence as we considered necessary." They also were required to report on whether the accounting principles were applied on a basis consistent with that of the preceding year. These changes are all for the better insofar as the standing of the profession is concerned, but actually have they had any effect on the work which the auditor does in arriving at his opinion on the affairs of the company?

Consistency

I am not aware of any discussion or movement under way proposing that the consistency of accounting principles from year to year be disclosed in Canadian practice. Probably the Income Tax Department is as interested as anyone on this phase of the accounts and they have their own inspectors who delve into these matters. Inventory valuation, depreciation accounting and contingent reserves are the accounts which would be the more common offenders against consistency. Has the auditor any obligations under present auditing standards to disclose those inconsistencies?

The fields in which the profession is serving becomes more diversified year by year. It is impossible for one man to keep up to date and fully informed on every feature which comes up even in simpler audits. The complexity of business aided and abetted by the complexities of government regulations requires us to change our thinking on office organization. Income tax, standard costs, special investigations, each calls for highly specialized training and an accountant's office must be prepared to cope with these problems. This requires men who have special training and ability, and also a meticulous supervision and allocation of accountants on a job. While recurring audits may well be the backbone of an accountant's practice, the opportunities of serving his clients and the community go far beyond the audit held.

The Securities and Exchange Commission in reports issued in December 1939 offered several suggestions which might strengthen the position of the auditor. Some of the suggestions were analagous to existing practice in Canada, but one in particular I feel is well worth some consideration: it is that the auditor should be required to attend meetings of stockholders at which his report is presented and be prepared to answer questions thereon. He should also have the right to make any statement or explanation he may desire in connection with the accounts. Under the Dominion *Companies Act,* he is entitled but not required to do so.

Auditor's Presence at Inventory Taking

It is interesting to note the difference in audit procedure in Canada, U.S.A., and in England with respect to inventories. In this country the attitude is that it is desirable but not mandatory to be present at the inventory-taking. In the U.S.A. it is mandatory providing it is practicable and reasonable, whereas in the U.K. no procedures have been laid down either under the *Companies Act* or by accounting bodies in respect of inventories, and it is not yet regarded as generally accepted auditing procedure in that country.

Aux Comptables Agréés

Avant de terminer mes commentaires sur les tendances dans la procédure de vérification j'aimerai à dire quelques mots aux bénéfices de mes collègues de langue française. J'ai fait remarquer que bien qu'il n'y ait pas en de changement depuis vingt-cinq ans dans les exigences de la loi des Compagnies tant Provinciale que Federale sur lesquelles est basé le rapport des vérificateurs des corporations publiques, l'envergure tous jours grandissante des entreprises apporte une responsabilité plus lourde de la part du vérificateur au service des actionnaires.

Dans notre profession aussi bien que dans les autres la tendance est à la spécialisation car aucune personne ne peut s'attendre à pouvoir maîtriser toutes les ramifications qui se présentent aujourd'hui, même dans une entreprise commerciales de moindre importance.

Professional Notes

ALBERTA

Messrs. William Macintosh, C.A., and Donald A. Ross, C.A., announce the formation of a partnership under the firm name of Macintosh, Ross & Co., Chartered Accountants, to continue the practice of William F. Reid & Co., Chartered Accountants, at 611 Lancaster Bldg., Calgary.

* * *

Messrs. John W. Devine, C.A. and Alan W. Bell, B.Com., M.B.A., C.A. announce the formation of a partnership for the practice of their profession under the firm name of Devine & Bell, Chartered Accountants, with offices in the Metropolitan Bldg., Lethbridge.

BRITISH COLUMBIA

Peat, Marwick, Mitchell & Co., Chartered Accountants, announce the opening of an office at 144 George St., Prince George, with Mr. David E. Fenton, C.A. as resident manager.

* * *

Messrs. R. Frank Rudd, C.A. and George W. Goold, C.A., announce the opening of an office for the practice of their profession under the firm name of Rudd & Goold, Chartered Accountants, 926 Standard Bldg., Vancouver.

Mr. Maurice S. Richmond, C.A. announces the opening of an office for the practice of his profession at 518 Vancouver Block, 736 Granville St., Vancouver.

* * *

Mr. C. D. L. Dyke, B.Com., C.A. announces the opening of an office for the practice of his profession at 2074 W. Fourth Ave., Vancouver.

* * *

Peat, Marwick, Mitchell & Co., Chartered Accountants, announce the removal of their offices to 410 Seymour St., Vancouver.

MANITOBA

Mr. Raymond B. Vopni, C.A. announces the admission to partnership of Mr. Darrel J. Sheridan, C.A. Henceforth practice of the profession will be conducted under the firm name of Vopni, Sheridan & Co., Chartered Accountants, 218A Grain Exchange Annex, Winnipeg.

ONTARIO

Messrs. L. C. Teskey, B.A., C.A., J. S. Petrie, C.A., and E. G. Burnside, C.A., formerly practising under the name of Hill, Teskey & Co., announce a change of firm name to Teskey, Petrie & Burnside, Chartered Accountants, with offices at 159 Bay St., Toronto.

Ampleford, Craig & Co., Chartered Accountants, announce the admission to partnership of Mr. John F. Broadhead, C.A. Henceforth practice of the profession will be conducted under the firm name of Ampleford, Craig & Broadhead, Chartered Accountants, with offices at 80 King St. W., Toronto.

* * *

Mr. Louis I. Powell, C.A., announces the removal of his offices to 315 Adelaide St. W., Toronto.

* * *

Arthur A. Crawley & Co., Chartered Accountants, announce the removal of their offices to 119 East St., Sault Ste. Marie.

* * *

Fred Page Higgins & Co., Chartered Accountants, Toronto, announce the opening of an office for the practice of the profession at 10 Suffolk St. E., Guelph.

Hamilton and District C.A. Association

The first dinner meeting of the season was held by the Hamilton and District Chartered Accountants Association at the Royal Connaught Hotel in early October. The meeting took the form of a panel discussion on the revisions to the Dominion and Ontario Companies Acts. The panel, under the chairmanship of J. S. Grant, C.A., included S. F. Ross, of Ross and Robinson, barristers; R. N. Steiner, of A. E. Ames & Co.; and R. Dale-Harris, C.A. A. W. Parish, C.A. was general chairman.

* * *

Mr. Joseph Kerzner, C.A. announces the opening of an office for the practice of his profession at 1016 Eglinton Ave. W., Toronto.

* * *

Mr. C. R. Simpson, C.A. announces the assumption of the practice formerly carried on under the name of MacDonald and Simpson, Chartered Accountants, Ottawa. He also announces the removal of his offices to 124 Holland Ave., Ottawa.

* * *

Mr. S. Percy Heiber, C.A. announces the removal of his offices to Ste. 2, 684 Church St., Toronto.

* * *

Messrs. John J. Kidd, C.A. and James T. F. Doctor, C.A. announce the formation of a partnership for the practice of their profession under the firm name of John J. Kidd & Co., Chartered Accountants, with offices at 61A Colborne St. E., Oakville.

QUEBEC

Mr. George F. Abbott, C.A., F.C.I.S. announces the resumption of practice of his profession at 114 University Tower Bldg., Montreal.

News of Our Members

Mr. Gordon F. McClary, C.A. (Alta.), was elected international president of the International Association of the Y's Men's Clubs at the 28th international convention held this year at the Banff Springs Hotel.

* * *

Mr. William D. McCubbin, C.A. (B.C.), has been appointed manager of the Victoria office of Accounting Corporation of America.

* * *

The appointment of Mr. D. A. Ross, C.A. (Alta., B.C.), as president and general manager of Canada Bread Company Ltd., Toronto, has been announced.

* * *

Mr. Walter W. B. Dick, C.A. (N.B., N.S., P.E.I.), is again giving leadership in improving hospital accounting systems in the Maritimes. He has just been named chairman of a committee to draft plans for an institute for hospital accountants and other administrative personnel. The long-range objective of the institute will be to establish a uniform accounting system in Maritime hospitals.

Mr. John F. Vaughan, C.A. (Ont.), has been appointed secretary-treasurer of the Port Weller Dry Docks Ltd.

* * *

Mr. J. M. Turnbull, C.A. (Ont.), has been appointed comptroller of The British American Oil Co. Ltd., Toronto.

* * *

Mr. Rosaire Courtois, C.A. (Que.), was a recent speaker at the annual meeting of the Chamber of Commerce of the Province of Quebec.

* * *

Mr. Gordon H. Nichol, C.A. (Que.), has been appointed general manager of Manchester Robertson Allison Ltd. He is also secretary-treasurer and a director of the firm.

Obituaries

Charles Edgar Stone

The Institute of Chartered Accountants of Ontario reports with sincere regret the death of Charles Edgar Stone in his 85th year.

Mr. Stone was born in London, England, and came to Canada in 1884 to serve as bookkeeper for his brother, a partner in a drapers' firm at King St. W., Toronto. In 1886 he joined Michie & Company, becoming secretary treasurer and, later, a partner, continuing in this position until the closing of the firm in 1947.

While with Michie & Company, he attended lectures of the Institute of Chartered Accountants of Ontario and was admitted to membership in 1891, after passing the final examination. He served on the Council of the Institute and gave lectures to the members on various occasions.

To his son and daughter, both of Toronto, the members of the Institute extend their sincere sympathy.

William Curran

The Institute of Chartered Accountants of British Columbia announces with deep regret the death of William Curran on September 26, 1952, in his 60th year.

Born in Belfast, Northern Ireland, Mr. Curran served in World War I with the Royal Fusiliers Regiment. He was admitted to the Institute of Chartered Accountants in Ireland in 1925. In 1929 he came to Canada and served with P. S. Ross & Sons and Price, Waterhouse & Co., Toronto. In 1939, Mr. Curran went to Vancouver and was employed with George A. Touche & Co. He moved to Kamloops, B.C. in 1948 and resided there until his death.

To his widow, two sons and daughter, the members of the Institute extend their sincere sympathy.

George Hunter

The Institute of Chartered Accountants of Quebec reports with deep regret the death of George Hunter on October 8 at the age of 64.

Born in Edinburgh, Mr. Hunter came to Canada in 1912 and entered the employ of the firm of Creak, Cushing & Hodgson 39 years ago. Prior to his retirement in 1951, he had been a partner of this firm for 31 years. In his younger days, he had been keenly interested in student instruction and served on the Institute's Board of Examiners from 1925 to 1935, and on the Council from 1937 to 1939. He also lectured on accountancy at McGill University, and was a trustee of the Beaverbrook Library, University of New Brunswick.

The members of the Institute wish to extend their deepest sympathy to his widow and family.

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

IN describing a "balance sheet audit" some students seem to have the idea that what one does is to confine his verification to the accounts of those items that appear on a balance sheet. But one cannot, for example, verify the figure for fixed assets appearing on a balance sheet by merely checking the fixed asset accounts in the ledger. One should also check the expense accounts because there may be some costs charged to expense that should have been charged to a fixed asset account instead. Further, an examination of the expense accounts may disclose some incompleted transaction for which neither the expense nor liability has been recorded; and an examination of the revenue accounts may disclose some item credited prematurely to revenue which should appear on the balance sheet as a liability. These are only examples, and the more one thinks about it, the more does he see how closely related are the balance sheet and the income statement.

* * * *

In *Contemporary Accounting,* published by the American Institute of Accountants, Samuel J. Broad has observed that public accountants in the United States are growing wary of the so-called "balance sheet audit" as a basis for expressing a professional opinion. As he puts it, "Another change which is gradually coming about in recent years . . . may be mentioned because it seems to indicate an unwillingness on the part of independent public accountants to express opinions based on limited examinations. It was formerly not unusual to make examinations for credit purposes which were confined almost entirely to the financial position as shown by the balance sheet and to furnish an opinion dealing with the balance sheet only and not the income statement. Such examinations are now comparatively rare. The increasing importance attached to earnings, from a credit standpoint as well as from the stockholder's standpoint, was probably also an important contributing influence."[1]

* * * *

When once we pass our C.A. examinations, how our outlook does change! Before we write the examinations, when we are struggling for success, and uncertain of it, we complain of the difficulty of passing and of the high number of failures. Then when we hear that golden news that we have passed (assuming we do), there is an almost unconscious straightening of the spine, and squaring of the shoulders, and we are heard to say that anyone with any brains can pass. Indeed, looking about us and noting that not

[1] *Contemporary Accounting,* Chapter 11, "Trends in Auditing and Reporting" by Samuel J. Broad, page 3.

all our fellow-C.A.'s are perfect, it is not long before we are of the opinion that the standards might well be raised. We are like Brutus when he mused,

That lowliness is young ambition's ladder,
Whereto the climber-upward turns his face;
But when he once attains the upmost round,
He then unto the ladder turns his back,
Looks in the clouds, scorning the base degrees
By which he did ascend.

(*Julius Caesar, Act II, Sc. I*)

CORRESPONDENCE

(RE PUBLISHED SOLUTION FOR QUESTION 2, FINAL ACCOUNTING II, OCTOBER 1951)

Quebec City, P.Q.

Sir: I am unable to agree with the calculation of "profit on disposal of trucks—$1,000" in Schedule 1 of Problem 4 in The Students' Department, August 1952, page 81. ..Should not the profit on disposal of trucks to be deducted from net profit shown in the accounts be computed as follows?

Cost of trucks traded in		$16,000
Depreciation on trucks traded in:		
3 years at 25% p.a.	$12,000	
9 mos. to 1 Aug. 1949 at 25%	3,000	
		15,000
Net book value		1,000
Trade-in allowance		5,000
Profit on disposal		$4,000

The fact that the company has depreciated the trucks up to the date of disposal seems to be indicated by the figure for truck depreciation charged during the year ended 31 Oct 1949 given in the problem—namely $23,-375. This figure is presumably made up as follows:

Depreciation for

12 mos. at 25% on $74,000 =	$18,500
9 mos. at 25% on $16,000 =	3,000
3 mos. at 25% on $30,000 =	1,875
	$23,375

In this case the non-taxable income for the 1949 fiscal year would be computed as follows:

Profit per books	$150,000
Less profit on disposal	4,000
	146,000
Less additional capital cost allowance claimed	10,000
Net taxable income	$136,000

A. P. DODD

Editor's note

We have checked Mr. Dodd's calculation and believe him to be correct (and the published solution incorrect) on the point he raises. We acknowledge that we were remiss in not having noted the point prior to publication and in not having dealt with it at least in an editor's note to the published solution. Our apologies.

A PUZZLE FOR CHRISTMAS

On Christmas Day, 1929, Father gave to the local hospital as many pounds as Monica was years old and as many shillings as Mabel was years old. On a subsequent Christmas Day, when Mabel was as old as Monica had been in 1929, he gave as many pounds as Mabel was years old and as many shillings as Monica was years old.

The second sum exceeded the first sum by ten shillings.

What is the difference in the ages of Monica and Mabel?

(submitted by a Vancouver reader)

Editor's note: A piece of interesting (but not necessarily vital) information is that there are 20 shillings in a pound.

SOLUTION TO NOVEMBER PUZZLE

2	9	4
7	5	3
6	1	8

PROBLEMS AND SOLUTIONS

Qualified accountants have prepared the solutions appearing in this section, and the solutions reflect the personal views and opinions of their various contributors. Students should not regard them necessarily as models for submission to the examiner. The hope is rather that they will provide a basis for such discussion and explanation of the problems as will make their study beneficial. The editor will welcome discussion of the solutions published.

PROBLEM 1

Final Examination, October 1951

Accounting III, Question 1 (20 marks)

CA has been asked by the president of A Co. Ltd., a company incorporated under The Companies Act, 1934 (Canada), to review the company's capital, surplus and reserve accounts, to suggest a presentation in the financial statements as at 31 Mar 1951 of the shareholders' equity which will conform with good accounting principles and legal requirements.

The following facts were discovered by CA in his review of the accounts:

(i) Capital stock—preferred

The company had authorized preferred share capital of 5,000 shares of 5% preferred, par value $100, redeemable at 105. 4,000 of these shares had been issued at a price of $102 as at 31 Mar 1950.

During the year ending 31 Mar 1951, 1,000 of these preferred shares were redeemed in accordance with s. 61 of *The Companies Act, 1934 (Canada)*. In this respect the par value of stock redeemed had been deleted from capital stock account and premium on redemption charged to premium on issue of preferred stock account. No further entries had been made in the accounts.

(ii) Capital stock—common

The original authorized common share capital was 15,000 shares of no par value. 10,000 of these shares had been issued at $70 per share.

One-seventh of the funds so received, had been set up under the provisions of section 12(7) of *The Companies Act, 1934 (Canada)*, as distributable surplus. During the year ending 31 Mar 1951, a split was made in common shares on the basis of 5 new shares for each old share.

(iii) **Reserves**

The following reserves had been set up by the company over a period of years and the balances in the accounts as at 31 Mar 1951 were as follows:

Reserves for contingencies	5,000
Reserve for preferred dividends maintenance	6,000
Reserve for depreciation on fixed assets	335,000
Reserve for bad debts	6,950
Reserve for employees' pensions	59,500
Reserve for modernization and expansion of plant	25,000
Reserve for bond sinking fund	150,000
Reserve for future decline in inventory	15,000
Reserve for taxes on income	9,000
Reserve for premium on future bond redemtpion	6,000
Reserve for fire insurance	3,500
Reserve for excessive cost of machinery replacements and new buildings	12,000
Reserve for foreign exchange arising from consolidation of branch accounts	3,555
Reserve for future advertising	15,890

(iv) **Surplus**

Surplus as at 31 Mar 1951 was made up as follows:

Undistributed earnings	$120,000
Capital surplus arising from appraisal of fixed assets	17,590
Distributable surplus	10,000

(v) **Sundry accounts—credit balances**

The balances as at 31 Mar 1951 in the undernoted accounts were as follows:

Refundable portion of excess profits tax	$ 80,000
Premium on issue of preferred capital stock	3,000
Subsidy monies paid by Federal Government	2,590
Profit on sale of fixed assets	750
Amounts received on war damage claim in excess of book value of foreign branch assets destroyed	3,500

Required:

Prepare the shareholders' equity section of the balance sheet of the A Co. Ltd. as at 31 Mar 1951.

For any of the items set out above which you do not include in the shareholders' equity section of the balance sheet, state where they would be shown in the financial statements.

A SOLUTION

(a)

A CO. LTD.

BALANCE SHEET
as at 31 Mar 1951

Shareholders' equity

Capital stock

Preferred — 5%

Authorized—5,000 shares of $100 par value, redeemable at 105

Issued—4,000 shares	$400,000	
Less redeemed during the year ended 31 Mar 1951 — 1,000 shares	100,000	
		$ 300,000

Common			
Authorized—75,000 shares of no par value			
Issued—50,000 shares			600,000
(During the year ended 31 Mar 1951 a split was made in the common shares on the basis of 5 new shares for each old share.)			
Premium on issue of preferred shares			6,000
Distributable surplus arising from the apportionment of the value assigned to no par value shares issued			10,000
Capital surplus arising from the redemption of preferred shares under section 61 of the Dominion Companies Act			100,000
			1,016,000
Undistributed earnings			
Undistributed earnings per statement attached		$103,840	
Reserve for bond sinking fund		150,000	
Reserve for foreign exchange		3,555	
Reserves for future contingencies:			
Preferred dividends maintenance	$ 6,000		
Modernization and expansion of plant	25,000		
Excessive cost of machinery replacements	12,000		
Premium on future bond redemption	6,000		
Future decline in inventory value	15,000		
Fire insurance	3,500		
Advertising	15,890		
General	5,000		
		88,390	
			345,785
Increase in value of fixed assets as a result of appraisal			17,590
			$1,379,375

(b) Reserve for depreciation on fixed assets — deducted from fixed assets
Reserve for bad debts — deducted from accounts receivable
Reserve for employees' pensions — long-term liability
Reserve for income taxes — current liability.

Editor's Note

"Undistributed earnings per statement attached" are calculated as follows:

Undistributed earnings per general ledger		$ 120,000
Add Refundable portion of excess profits tax	$80,000	
Subsidy monies paid by Federal Government	2,590	
Profit on sales of fixed assets	750	
Amounts received on war damage claim in excess of book value of foreign branch assets destroyed	3,500	
		206,840

Deduct Transfer to capital surplus under s. 61 of the Dominion *Companies Act*	100,000	
Portion of premium paid on redemption of preferred stock not covered by premium received at time of issue 1,000 x ($5 - $2)	3,000	
		103,000
"Undistributed earnings per statement attached"		$ 103,840

PROBLEM 2

Final Examination, October 1951

Accounting III, Question 2 (20 marks)

The X Co. Ltd. sells its entire output to the X Distributing Co. Ltd. at cost plus 20%. As the costs of sales cannot be determined until the year end, billings are made throughout the year on an estimated basis. At the year end the adjustment is put through to adjust the selling prices to the agreed cost plus 20% as determined by the ascertained costs.

In determining cost, freight out is to be included but selling and general administration expenses and purchase discounts are not.

If the X Distributing Co. Ltd. is able to maintain a higher mark-up than 40%, based on its cost, such excess gross profit shall be divided equally with the X Co. Ltd. Such amounts, if any, are to be treated as payments to X Co. Ltd. in return for exclusive agency rights, and are not to affect the gross profit of either company.

The trial balance of X Co. Ltd. as at 31 Oct 1951, adjusted except for inventories is as follows:

	Dr.	Cr.
Cash	$ 8,500	
Accounts receivable—X Distributing Co. Ltd.	25,469	
Inventories—1st November 1950		
—raw material	23,450	
—goods in process	21,550	
Machinery and equipment (net)	23,400	
Accounts payable		$ 3,400
Capital stock		66,000
Earned surplus		3,514
Sales (estimated billing for the year)		188,430
Purchases	84,350	
Direct labour	31,590	
Indirect labour	5,450	
Freight in	859	
Light, heat and power	5,500	
Rent — factory	6,000	
Depreciation — machinery and equipment	2,600	
Repairs to equipment	1,445	
Miscellaneous manufacturing expense	4,490	
Freight out	1,466	
Office salaries and expenses	13,500	
Discount on purchases		1,275
Advertising	3,000	
	$262,619	$262,619

Inventories X Co. Ltd. as at 31 Oct were as follows:

Raw materials	$ 27,650
Goods in process	18,350

The pertinent accounts of the X Distributing Co. Ltd. as at 31 Oct 1951 were as follows:

Sales	$254,550
Opening inventory (already adjusted for 1950)	23,023
Purchases (estimated billings)	188,430
Final inventory (estimated billings)	31,097

Required:

(15 marks) (a) Statements for the year ending 31 Oct 1951 showing the calculation for the X Co. Ltd. of the cost of goods sold and billings as per contract and for the X Distributing Co. Ltd. of the gross profit.

(5 marks) (b) Journal entries, complete with narratives, to adjust the X Co. Ltd. books for the transactions with X Distributing Co. Ltd.

A SOLUTION

(a)

X CO. LTD.

Statement of Cost of Goods Sold

for year ending 31 Oct 1951

Inventories 1 Nov 1950:		
Goods in process		$ 21,550
Costs of production:		
Raw material inventory 1 Nov 1950	$ 23,450	
Purchases	84,350	
Freight in	859	
	108,659	
Less inventory 31 Oct 1951	27,650	
Raw material cost		81,009
Direct labour		31,590
Factory service:		
Indirect labour	5,450	
Light, heat and power	5,500	
Rent — factory	6,000	
Depreciation, machinery and equipment	2,600	
Repairs to equipment	1,445	
Miscellaneous manufacturing expense	4,490	25,485
		$159,634
Less: Inventory goods in process 31 Oct 1951		18,350
Cost of goods sold		141,284
Plus freight out		1,466
		$142,750

X CO. LTD.
Billings to X Distributing Co. Ltd.
for year ending 31 Oct 1951

Cost of sales per statement	$142,750
Plus 20%	28,550
Billings	$171,300

X DISTRIBUTING CO. LTD.
Statement of Gross Profit
for year ending 31 Oct 1951

Sales		$254,550
Cost of goods sold:		
Inventory 1 Nov 1951	$ 23,023	
Purchases	171,300	
	194,323	
Less: inventory adjusted*	28,270	166,053
Gross profit		$ 88,497
(40% of cost = $66,421)		
½ of excess of gross profit over 40% cost due to X Co. Ltd.		11,038
Profit		$ 77,459

*Final inventory adjusted is

$$31{,}097 \times \frac{171{,}300}{188{,}430} = \$28{,}270$$

(b) X CO. LTD. JOURNAL

Sales	$ 17,130	
Agency rights — revenue		$ 11,038
Accounts receivable, X Distributing Co. Ltd.		6,092
To adjust the accounts for transactions with X Distributing Co. Ltd.		

PROBLEM 3
Final Examination, October 1951
Accounting III, Question 3 (12 marks)

The XYZ Co. Ltd. took steps to retain the services of the three key employees who constituted the active management of the business.

As a result the following agreement was entered into on 1 Jan 1946:

(a) For a period of five years from the date of the contract, R, the comptroller and general manager, and S, the purchasing agent, were each to receive salaries of $800 per month and a bonus of 6% of the profits of the company before depreciation, mortgage interest, income taxes and such bonuses.

(b) For a period of five years from the date of the contract T, the sales manager, was to receive a commission of 1% on all sales of the company.

(c) A pool, made up of R, S and T, was to be granted the option to purchase on or before 1 Dec 1950, 70% (2,100 shares) of the outstanding capital stock of XYZ Co. Ltd. The price per share was to be 8 times the average annual earnings per share during the five-year period of the contract.

(d) The determination of the price and terms of payment were to be agreed on at the close of the 1950 fiscal year.

For five years ending 31 Dec 1950, sales, etc. of the XYZ Co. Ltd. were as follows:

	1946	1947	1948	1949	1950
Sales	$1,500,000	$1,200,000	$1,600,000	$1,900,000	$2,200,000
Profit after all expenses, including bon--uses, except depreciation, income tax and mortgage interest	62,000	44,000	70,000	105,000	175,000

The net profit or loss for each year is to be computed assuming depreciation of $25,000 per annum on the fixed assets of the business, interest of $15,000 per annum paid or accrued on first mortgage bonds and income taxes calculated at an arbitrary rate of 45%.

Required:

(6 marks) (a) Statement showing the amounts due to R, S and T under the contract for each of the 5 years ending 31 Dec 1950.

(6 marks) (b) Statement showing the price per share to be paid by R, S. and T, in accordance with the contract.

A SOLUTION

(a)

THE XYZ CO. LTD.

STATEMENT OF PROFIT ON WHICH BONUS TO R AND S IS BASED

	1946	1947	1948	1949	1950
Profit after all expenses except depreciation, income taxes and mortgage interest	$62,000	$44,000	$70,000	$105,000	$175,000
Profit on which R and S bonus is based (above figure x 100%) / 88%	70,454	50,000	79,545	119,318	198,864

Statement of amounts due to R, S and T
for each of five years
ending 31 Dec 1950

	1946	1947	1948	1949	1950
R — salary	$ 9,600	$ 9,600	$ 9,600	$ 9,600	$ 9,600
— bonus — 6%	4,227	3,000	4,773	7,159	11,932
	$13,827	$12,600	$14,373	$ 16,759	$ 21,532
S — same as above	$13,827	$12,600	$14,373	$ 16,759	$ 21,532
T — commission	$15,000	$12,000	$16,000	$ 19,000	$ 22,000

(b) Statement of Price per Share
to be paid by R, S and T
re purchase option

	1946	1947	1948	1949	1950
Profit — per above	$62,000	$44,000	$70,000	$105,000	$175,000
Less					
Depreciation	25,000	25,000	25,000	25,000	25,000
Mortgage Interest	15,000	15,000	15,000	15,000	15,000
	$22,000	$ 4,000	$30,000	$ 65,000	$135,000
Less					
Income tax	9,900	1,800	13,500	29,250	60,750
Net Profit	$12,100	$ 2,200	$16,500	$ 35,750	$ 74,250

Total net profit		$140,800
Average net profit	$140,800 / 5	28,160
Outstanding capital stock — 3,000 shares		
Average rate of annual earning per share	28,160 / 3,000	$9.3867
Price to be paid by R, S and T	8 x $9.3867	$75.094 per share